STATE OF MONTANA

DEPARTMENT OF REVENUE

INCOME AND CORPORATION TAX DIVISIONS

REPORT ON EXAMINATION OF INDIVIDUAL INCOME TAX AND CORPORATION LICENSE AND INCOME TAX REVENUES AND ACCOUNTS RECEIVABLE

Fiscal Year Ended June 30, 1975

OFFICE OF THE LEGISLATIVE AUDITOR

STATE OF MONTANA

STATE CAPITOL • HELENA

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ADMINISTRATIVE OFFICIALS

William A. Groff	Director, Department of Revenue
Laury M. Lewis	Deputy Director, Department of Revenue
Donald E. Bentson	Administrator, Audit and Accounting Division
Gerald L. Foster	Administrator, Corporation Tax Division
Howard O. Vralsted	Administrator, Income Tax Division

SUMMARY OF RECOMMENDATIONS

As a separate section in the front of each audit report we include a listing of all recommendations together with a notation as to whether the agency concurs or does not concur with each recommendation. This listing serves as a means of summarizing the recommendations contained in the report and the audited agency's reply thereto and also as a ready reference to the supporting comments. The full reply of the Department of Revenue is included in the back of this report.

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Study and implement alternatives to the present tax receipts processing methods to minimize deposit delays.	8
Agency Reply: Concur. See page 56.	
Hire temporary staff or authorize overtime during peak periods to expedite the deposit of tax receipts.	8
Agency Reply: Concur. See page 56.	
Provide adequate security for unprocessed mail.	8
Agency Reply: Concur. See page 56.	
Make deposits with the State Treasurer's Office at the end of each work day to facilitate maximum investment earnings for the state.	9
Agency Reply: Concur. See page 56.	
Eliminate credit balances in accounts receivable, correct data entry errors, and revise computer produced reports to provide more meaningful information.	13
Agency Reply: Concur. See page 57.	
Automate pre-1974 individual income tax receivables to provide meaningful management information relating to these receivables.	13
Agency Reply: Concur. See page 57.	
Evaluate all present receivable systems and interface them with the Statewide Budgeting and Accounting System and with each other.	13
Agency Reply: Concur. See page 57.	

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Consider consolidating accounts receivable recordkeeping in the Audit and Accounting Division to correct existing internal control weaknesses.	13
Agency Reply: Concur. See page 57.	
Evaluate active and potential data processing systems to determine problem areas and obtain the capability to meet the needs of the department.	14
Agency Reply: Concur. See page 57.	
Disclose uncollectible accounts receivable on its financial statements in accordance with generally accepted accounting principles.	15
Agency Reply: Concur. See page 57.	
Report known unpaid income tax refunds as payables and accordingly decrease reported tax revenues in the department's financial statements.	16
Agency Reply: Do not concur. See page 57.	
Establish procedures to insure compliance with small business corporation tax requirements.	18
Agency Reply: Aware that improvements are needed. See page 58.	
Institute written procedures manuals for all sections and establish a system to maintain the manuals on a current basis.	21
Agency Reply: Concur. See page 58.	
Institute adequate individual income tax return review procedures to insure adequacy of instructions and compliance with state statutes.	23
Agency Reply: Concur. See page 58.	
Provide two toll-free taxpayer assistance telephone lines during the months of January through April.	24
Agency Reply: Concur. See page 59.	
Lower the keypunch error rate by requiring verification of all information keypunched into the individual income tax computer files or by alternative procedures.	26
Agency Reply: Concur. See page 59.	

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Require in-process returns to be locked in file cabinets after normal working hours.	28
Agency Reply: Concur. See page 59.	
Limit access to the block room at all times with central filing and typing section personnel assigned the responsibility of pulling, signing out and re-filing returns for other division employees.	28
Agency Reply: Concur. See page 59.	
Make comparisons with IRS information computer tapes on a current basis to insure prompt follow up of discrepancies.	29
Agency Reply: Concur. See page 59.	
Re-evaluate the compliance section staffing level.	30
Agency Reply: Concur. See page 59.	
Insure that the collection section has adequate field collection support.	32
Agency Reply: Concur. See page 60.	
Establish effective procedures to determine which taxpayers failed to properly declare and pay estimated tax.	34
Agency Reply: Do not concur because of the department's position that it has no authority to assess penalties relating to estimated tax. See page 60.	
Assess penalties in accordance with Section 84-4924, R.C.M. 1947.	34
Agency Reply: Do not concur because of the department's position that it has no authority to assess such penalties. See page 60.	
Revise the withholding delinquency notice system to properly notify employers who fail to meet withholding reporting deadlines.	35
Agency Reply: Concur. See page 61.	
Remove inactive employers from mailing lists for quarterly withholding reports (MW-5's).	35
Agency Reply: Concur. See page 61.	

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Follow-up promptly on employers not complying with withholding delinquency notices.	35
Agency Reply: Concur. See page 61.	
Assess penalties for failure to file timely MW-10's and MW-2's in accordance with Sections 84-4924 and 84-4954, R.C.M. 1947.	36
Agency Reply: Do not concur because of the department's position that legislative intent was not to apply the rather severe criminal penalties of Section 84-4924(3) to pretax, i.e., informational returns. See page 61.	
Complete a timely review of employer withholding records on an annual basis after receipt of the annual withholding reconciliations (Form MW-10) and follow up discrepancies noted.	37
Agency Reply: Concur. See page 62.	
Implement a withholding field audit program to review Montana employer compliance with state withholding requirements.	39
Agency Reply: Concur. See page 62.	
Work with the Montana Department of Labor and Industry in coordinating employer audit programs to insure maximum employer compliance at a minimum of inconvenience to employers.	39
Agency Reply: Concur. See page 62.	
Study and select a feasible procedure for comparison of W-2's submitted by employers and taxpayers to ensure compliance with Montana statutes.	41
Agency Reply: Concur. See page 62.	
Expand its individual income tax field audit activities to provide adequate review of taxpayer compliance.	42
Agency Reply: Concur. See page 62.	
Require adequate documentation of individual income tax return tests and field audit work completed.	43
Agency Reply: Concur. See page 62.	

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Assess appropriate penalties and interest and seek prosecution against apparent tax evaders as required by Section 84-4924, R.C.M. 1947.	45
Agency Reply: Concur. See page 63.	
Require strict adherence to its corporate tax return review procedures.	47
Agency Reply: Concur. See page 63.	
Refund minimum corporation license tax payments received from inactive corporations in compliance with the Montana Administrative Code.	48
Agency Reply: Concur. See page 63.	
Disallow the deduction of estimated bad debts in compliance with Section 84-1502, R.C.M. 1947, or seek legislation allowing a deduction which conforms with federal tax law.	49
Agency Reply: Concur. See page 63.	
Adequately document supervisory reviews of corporate tax accounts receivable credit adjustments.	49
Agency Reply: Concur. See page 63.	
Include a written audit program in all corporate tax field audit working papers.	50
Agency Reply: Appear to concur. See page 63.	
Audit small business and domestic corporations to insure compliance with Montana regulations.	51
Agency Reply: Concur. See page 64.	

MORRIS L. BRUSETT
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To the Legislative Audit Committee
of the Montana State Legislature:

We have examined the individual income tax and corporation license and income tax revenues and the related accounts receivable and accounts payable of the Income Tax and the Corporation Tax Divisions of the Montana Department of Revenue as of June 30, 1975 and for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances except as described in the following paragraphs.

The Income Tax and Corporation Tax Divisions rely almost exclusively on the Internal Revenue Service's compliance and enforcement program for field audits of individual taxpayers, small business and domestic corporations. Due to the provisions of the state's contract with the federal government, we were denied access to the results of the Internal Revenue Service's compliance program and the state's follow-up of compliance exceptions.

As described on page 9 of this report the Income Tax Division did not have adequate records to support the balance of pre-1974 individual income tax receivables included in the accounts receivable balance as of June 30, 1975. We were unable to reconstruct this balance, and therefore, we do not express an opinion as to the fairness of individual income tax receivables.

Debit and credit balances of withholding tax accounts receivable were combined, contrary to generally accepted accounting principles. As a result, at

June 30, 1975, the withholding tax receivables were understated by approximately $116,000. Accounts payable were understated by an undetermined amount, since it was not practical to determine the total amount of payment recording errors which caused credit balances. Due to an accounting error, Corporation Tax Division receivables were understated by $209,755 as described on page 11.

The department did not disclose significant uncollectible accounts receivable from taxes due at June 30, 1975. Such disclosure is required by generally accepted accounting principles.

The department did not report accounts payable for income tax refunds of approximately $183,000 for the Income Tax Division and $215,000 for the Corporation Tax Division at June 30, 1975, as required by generally accepted accounting principles. Known income tax refunds should have been recorded as liabilities and reductions of revenue at the time the refund claims were filed with the department. As a result, liabilities were understated by approximately $398,000, and revenues were overstated by the same amount.

In our opinion, because of the effects of the matters described above relating to withholding tax and corporation license and income tax accounts receivable and accounts payable, these receivables and payables are not fairly presented in accordance with generally accepted accounting principles. Because of the department's significant reliance on the Internal Revenue Service's compliance and enforcement program for field audits and our inability to review the results of this program, as described above, we do not express an opinion as to the fairness of individual income tax and corporation license and income tax revenues for fiscal year 1974-75.

Respectfully submitted,

Morris L. Brusett

Morris L. Brusett, C.P.A.
Legislative Auditor

May 17, 1976

COMMENTS

GENERAL

The Montana Department of Revenue was created in 1971 under the Executive Reorganization Act. The department's director is appointed by, and serves at the pleasure of the Governor. The department presently consists of 13 divisions:

1. Audit and Accounting
2. Legal
3. Investigation
4. Research
5. Operations
6. Data Processing
7. Liquor
8. Income Tax
9. Property Assessment
10. Corporation Tax
11. Motor Fuel Tax
12. Miscellaneous Tax
13. Inheritance Tax

We conducted a financial/compliance audit of the income and corporate tax collection and processing procedures of the Income and Corporation Tax Divisions for fiscal year 1974-75 with related audit testing done in the Audit and Accounting Division. The audit report issued by Newland, Horn and Taylor, P.S.T., in December 1975 covered the other activities of these two divisions, as well as activities of the other divisions within the Department of Revenue for fiscal year 1974-75.

The Income Tax Division is responsible for the administration of Montana individual income tax laws; and the Corporation Tax Division is responsible for the administration of the Montana corporation license and income tax laws. The Audit and Accounting Division is responsible for providing accountability over all assets, liabilities, revenues, and expenditures of the department and conducts internal audits of the department's operations.

The first section of this report deals with the general operations within the department which affect the Income and Corporation Tax Divisions. The second and third sections discuss in detail the operations of the Income and Corporation Tax Divisions.

DEPARTMENT OF REVENUE PROCEDURES

Tax Receipt Processing and Depositing Procedures

The department's mail room handles all mail received by the department including individual and corporation income tax forms and receipts. The mail room staff normally opens all mail except that marked "personal," which is delivered directly to the appropriate individual. The mail opened by mail room personnel is sorted, and documents with payments are sent to the department's cashier section. Non-remittance documents are sent directly to the appropriate division for necessary processing.

The cashier section is responsible for processing and depositing tax receipts with the State Treasurer's Office. The section's procedures include: verifying the payment amount with the amount shown as due on the tax form; assigning a cashier receipt number to the tax form (this procedure is completed in the mail room during the busy tax season around April 15); restrictively endorsing the payment, if applicable; preparing deposit tickets; and making deposits with the State Treasurer's Office. The Audit and Accounting Division completes the collection reports which accompany each deposit delivered to the State Treasurer's Office around mid-morning of each Monday through Friday.

Our audit and that conducted by Newland, Horn and Taylor, P.S.T., disclosed that deposit delays of several days to several weeks are not unusual. Longer delays are particularly noticeable during the individual income tax season around April 15 of each year.

During the peak period of April 1975 the mail room was unable to process mail the same day received. The mail room supervisor told us that the mail room processing of individual income tax returns received during April 1975 was not completed until May 9, 1975. We examined a

sample of individual income tax payments received by the mail room prior to April 21, 1975, and found that some of these payments were not deposited with the State Treasurer's Office until May 28, 1975. The delays on the sample returns ranged from 1 to 38 days with an average delay of 18 days.

During April 1976 visits to the mail room and cashier section showed that similar problems still exist. At the end of three work weeks, we estimated the following amounts of unprocessed mail:

Date	Pieces of Unprocessed Mail
Friday, April 9, 1976	3,000
Friday, April 16, 1976	48,600
Friday, April 23, 1976	23,400

As a result of this backlog, large amounts of unprocessed mail and receipts remained overnight in the mail room. The mail room supervisor said that at times mail bags have even been left in the hallway when there is a lack of storage space in the mail room itself.

The mail bags kept in the mail room overnight are safeguarded only by the lock on the mail room door since the mail bags are not sealed or locked. The mail bags left in the hall have no security at all, and anyone in the building after hours could easily carry off the mail bags. Another problem is the fact that the janitorial staff have master keys which allow them to enter the mail room during non-working hours, giving them access to the mail bags.

The inadequate security over unprocessed tax receipts is a serious internal control weakness because of the large number of unendorsed checks, money orders and cash, as well as confidential information contained in the mail bags. The department must develop better security over unprocessed mail to safeguard it against theft.

The cashier section also has been unable to process and deposit tax receipts the same day they are received from the mail room. During April 1976 we estimated the following amounts of undeposited tax receipts (from all types of taxes) in the cashier section at the start of three work weeks:

Date	Undeposited Receipts
Monday, April 12, 1976	$1,637,000
Monday, April 19, 1976	2,230,000
Monday, April 26, 1976	2,734,000

The fact that these deposits remained in the cashier's office over the three weekends resulted in an investment income loss to the state. As described above, the delay in deposit of these receipts is as much as 38 days. The cashier estimated that her section would be up to 12,000 individual income tax returns behind before the 1976 income tax season rush was over and would not be caught up until sometime in May.

These processing delays are attributable to a combination of staffing and procedural problems. The mail room hires up to eight additional temporary personnel and the cashier section hires one additional temporary worker, but as documented above, neither section has been able to process mail and deposit receipts promptly. The department has only one shift of personnel processing tax receipts. The use of at least two shifts would considerably expedite the processing. The department must also simplify and speed up its tax deposit procedure. Once this has been done, the need for additional staff should decrease.

The most serious procedural problem is that the cashier section spends an excessive amount of time processing receipts before they are deposited. The department should evaluate the present cashier section procedures and eliminate those procedures not required so that they may expedite the deposit of tax receipts.

There are many possible alternatives to the present procedures, ranging from the use of simple validators to computerized systems. Validators would provide centralized assignment of cashier numbers, recordation of amount of tax paid and date received on the tax return and a continuous summary of receipts which can readily be totalled at deposit time. Accomplishing these tasks through one manual procedure could considerably expedite the deposit process. The department, which recently began to look for a system to replace the cashier section manual procedures and adding machines, must evaluate the alternatives available, carefully considering processing speed, additional interest revenue which could be earned and system costs.

Any delays in the processing and depositing of these tax receipts prevents the state from utilizing or investing tax funds to the fullest extent. Therefore, it is essential that the mail room and cashier section work together to process and deposit tax receipts with the State Treasurer's Office in a timely and efficient manner.

RECOMMENDATION

We recommend that the department:

1. *Study and implement alternatives to the present tax receipts processing methods to minimize deposit delays.*
2. *Hire temporary staff or authorize overtime during peak periods to expedite the deposit of tax receipts.*
3. *Provide adequate security for unprocessed mail.*

Deposit Coordination

In our review of undeposited receipts, we found large amounts of receipts that had been completely processed by the cashier section, but

not yet deposited with the State Treasurer's Office. This results because the cashier section processes receipts through the end of each work day and makes deposits near mid-morning of the next day. The department's deposit does not reach the State Treasurer's Office in time to be processed by them and included in their morning deposit with Helena banks, so it is not deposited until the next morning.

By failing to make the deposit with the State Treasurer at the end of each work day so the State Treasurer's Office can include the money in its morning deposit, the department is causing a one day delay in each deposit's being invested for the state's benefit. As a result, the state lost interest of approximately $18,200 on individual and corporation income tax deposits alone during fiscal year 1974-75. There are additional losses on other taxes processed through the cashier section.

RECOMMENDATION

We recommend that the department make deposits with the State Treasurer's Office at the end of each work day to facilitate maximum investment earnings for the state.

Accounts Receivable

Our review of the Income and Corporation Tax Divisions' accounts receivable revealed serious problems. The department has not yet established a centralized accounts receivable system for all its divisions as recommended by the Office of the Legislative Auditor in 1969. The Income and Corporation Tax Divisions utilize separate accounts receivable systems which do not interface with the Statewide Budgeting and Accounting System (SBAS) or each other. The Audit and Accounting Division manually inputs accounts receivable information into SBAS at fiscal

year-end by journal voucher. The following schedule explains the separate accounts receivable systems being used by Income and Corporation Tax Divisions:

Division/Section	Balance 6/30/75	Manual System	Computerized System	Interfaced with SBAS
INCOME TAX DIVISION				
Central Filing and Typing Section - pre-1974 income tax accounts receivable	$ 100,000 (estimated)	Yes	No	No
Central Filing and Typing Section - 1974 and 1975 income tax accounts receivable	828,777	No	Yes	No
Withholding Section - withholding tax accounts receivable	295,199	No	Yes	No
CORPORATION TAX DIVISION				
Corporation Tax Accounts Receivable	1,403,528	Yes	No	No
TOTAL	$2,627,504			

The accounts receivable system for the withholding section contained numerous errors which precluded us from determining the fairness of the June 30, 1975, balance of $295,199. These errors resulted from payments being recorded for accounts receivable that had not been established in the computer system and from payments that had been recorded more than once for established accounts receivable.

The Audit and Accounting Division combined the total debit and credit balances to obtain the withholding receivable balance reported as of June 30, 1975. Actual overpayments of accounts receivable and payments recorded more than once should not have been deducted from the debit balance. By combining the total debits and credits, the Audit and Accounting Division understated the accounts receivable and accounts payable balances by an undetermined amount.

The withholding section's two computer produced accounts receivable reports reviewed during our work did not provide adequate aging information. This information would enable management to readily evaluate

the effectiveness of the tax collection procedures and initiate changes if required. This information is also essential in determining account collectibility. By evaluating collectibility, management can write off through proper channels, those accounts determined to be uncollectible.

The central filing and typing section maintains a tax receivable system for individual income tax receivables. While the system has been computerized, it only includes receivables for the 1974 tax year or later. Older accounts are in an alphabetic card file and have not been computerized. We were unable to determine that these income tax receivables were fairly stated because the June 30, 1975 balance of $854,289 reported in the department's financial statements included an estimate of the pre-1974 accounts, which was not adequately supported by detailed accounts. As shown in the above table of accounts receivable, central filing and typing section officials estimated that the total amount of income tax receivables more nearly approximated $928,777 at June 30, 1975. We could not reconstruct the pre-1974 accounts as of June 30, 1975 because of the manner in which the card file for these receivables is maintained. The pre-1974 accounts should be included in the computer system in order to provide meaningful, current information.

While the manual Corporation Tax Division receivable system provided better controls, the June 30, 1975 balance of $1,403,528 was understated by $209,755. An incorrect journal voucher entry by the Audit and Accounting Division recorded what was actually an increase in the accounts receivable balance as a credit (decrease), thereby causing the understatement.

Newland, Horn and Taylor's audit report on the department for the fiscal year ended June 30, 1975, recommended that the department's

accounts receivable system be computerized and tied to the Statewide Budgeting and Accounting System (SBAS). We concur and believe it essential that such a system be initiated in the Corporation Tax Division. Under the present system, the division administrator only receives reports on receivable balances every six months. A monthly summary with aging of the various accounts would be more meaningful, and a computerized system could produce billing notices which presently are not being sent out on a timely basis. Such a system would also prevent recurrence of recording errors such as those made during fiscal year 1974-75.

Because of the present makeup of these separate accounts receivable systems, there is inadequate internal control over the accounts receivable balances. Each section is responsible for sending out its own assessment notices and recording payments received on its own system. The cashier section assigns a cashier number to each payment received, but there is no actual reconciliation between the accounts receivable and SBAS records, therefore allowing a possible mishandling of accounts.

A possible solution would be the establishment of a centralized accounts receivable function within the Audit and Accounting Division to handle all accounts receivable existing in the department. Each section would be responsible for sending out the initial billings, as well as followup notices based on aging reports provided by the Audit and Accounting Division. The needed separation of duties would be accomplished because the various section personnel would have no control over recording of payments received. This procedure would be completed by the Audit and Accounting Division and would provide reconciliation with SBAS records.

RECOMMENDATION

We recommend that the department:

1. *Eliminate credit balances in accounts receivable, correct data entry errors, and revise computer produced reports to provide more meaningful information.*
2. *Automate pre-1974 individual income tax receivables to provide meaningful management information relating to these receivables.*
3. *Evaluate all present receivable systems and interface them with the Statewide Budgeting and Accounting System and with each other.*
4. *Consider consolidating accounts receivable recordkeeping in the Audit and Accounting Division to correct existing internal control weaknesses.*

Data Processing Operation and Funding

During our audit we encountered serious problems with inadequate or inefficient data processing systems. Problems we found included the following:

1. When asked why various testing procedures were not computerized, we were often given the answer that there was a lack of funding or a shortage of programmers.
2. The individual income tax return computerized master file for calendar year 1974 returns did not provide summary totals of tax receipts and refunds which would enable reconciliation with SBAS records.
3. At least 25,000 individual income tax return mathematical errors found through the error resolution process described on

page 20 were overridden by the auditors rather than being corrected during 1975; therefore, the validity of the master file is questionable for use in estimating revenue as is presently done by the department's Research Division.

4. There were serious problems with the withholding section's accounts receivable system which necessitated bringing in assistance from the Department of Administration's Data Processing Division.

The department's Data Processing Division is a relatively new operation and is still in the developmental stages regarding staffing and systems planning. The problems mentioned above resulted primarily from an inadequate data processing staff.

The Montana legislature appropriated $130,000 to enable the department to develop and maintain an automated accounts receivable system during the 1975 biennium. Although this funding was the amount requested by the department to implement such a system, the department's priorities dictated completion of other data processing systems before starting on the accounts receivable system. As a result of these priorities and an inadequate data processing staff, the department did not complete effective accounts receivable systems during the 1975 biennium.

RECOMMENDATION

We recommend that the department evaluate active and potential data processing systems to determine problem areas and obtain the capability to meet the needs of the department.

Disclosure of Uncollectible Accounts Receivable

Generally accepted accounting principles require disclosure in the financial statements of offsets to assets included on the balance sheet. We found the Income Tax Division and Corporate Tax Division have significant uncollectible accounts receivable from taxes due. No disclosure of these uncollectible receivables is made in Department of Revenue financial statements for fiscal year 1974-75.

RECOMMENDATION

We recommend that the department disclose uncollectible accounts receivable on its financial statements in accordance with generally accepted accounting principles.

Accounts Payable

Generally accepted accounting principles require recording of known income tax refunds as liabilities and reductions of revenue at the time the refund claims are filed with the taxing authority. The department failed to meet this requirement by not reporting known unpaid tax refund balances for the Income and Corporation Tax Divisions on its June 30, 1975 financial statements. Since most of the individual income tax refunds were paid in July, these amounts were known at the time the department's year-end accounting entries were made. The Audit and Accounting Division administrator stated that these refunds were accounted for on the cash or as paid basis.

Based on accounts payable information provided by Income and Corporation Tax Division personnel, we estimate that Income Tax Division liabilities were understated by at least $183,000 and Corporation Tax

Division liabilities were understated by as much as $215,000. Revenues for the two divisions were overstated by equal amounts.

RECOMMENDATION

We recommend that the department's financial statements report known unpaid income tax refunds as payables and accordingly decrease reported tax revenues.

Small Business Corporation Income Distribution

Sections 84-4901 through 4903 and 84-4905, R.C.M. 1947, require that small business corporation stockholders pay individual income tax on wages received from such corporations and any proportionate share of corporation profits. Section 42-2.6(1)-S6080 of the Montana Administrative Code states that a small business corporation election is invalid if any shareholder fails to report his share of corporate net income or loss on his Montana Individual Income Tax Return for the taxable year in which the taxable year of the corporation ends. Neither the Income Tax Division nor the Corporation Tax Division has established adequate procedures to insure compliance with these requirements.

Although the Corporation Tax Division receives and maintains information returns submitted by small business corporations, the department makes no effort to insure that small business corporation stockholders are properly reporting their small business corporation income or loss to the Income Tax Division. Likewise, the Income Tax Division does not routinely trace such distributions to individual income tax returns. If an individual income tax return selected for audit by the Income Tax Division reports a small business corporation distribution, the audit section will confirm the reported amounts with the Corporation Tax

Division. If a stockholder does not report his small business corporation earnings on his individual income tax return, the Income Tax Division has no way of determining that such income is unreported. Such detection is not possible because small business corporation returns are filed at the Corporation Tax Division by corporation name rather than by individual stockholder name.

In our review of a sample of 34 small business corporation returns, we found 14 individual taxpayers who failed to report small business corporation income on their individual income tax returns. The 14 exceptions represented a total of $38,000 of unreported income derived from small business corporations, with the most significant being three individuals who failed to report respectively $15,758, $13,962 and $6,871.

The purpose of allowing the establishment of small business corporations was to give stockholders a tax break by taxing only the individual distributions rather than corporation income as well. When small business corporation stockholders fail to report their small business corporation income, the Corporation Tax Division is responsible for revoking the small business corporation status of the related corporations. The Corporation Tax Division should be taxing all small business corporations with non-reporting stockholders as regular corporations, and the Income Tax Division should be collecting taxes from the non-reporting stockholders on their wages and shares of the distributed corporate income.

The Income and Corporation Tax Divisions must cooperate closely to insure proper compliance with small business corporation tax requirements. While a computerized comparison would be most effective in

determining non-reporting stockholders, the fact that the two divisions' computer files are not compatible precludes such a comparison without major revisions. Whether the computer files are revised or a manual system established, such tests are necessary to insure compliance with small business corporation tax requirements. The Corporation Tax Division should supply the Income Tax Division with lists of small business corporation stockholders so that compliance tests can be made.

RECOMMENDATION

We recommend that the department establish procedures to insure compliance with small business corporation tax requirements.

INCOME TAX DIVISION

During fiscal year 1974-75, the Income Tax Division consisted of the Income Tax Bureau and the Inheritance Tax Bureau. Our audit scope in this division was limited to the income tax collection and processing procedures of the Income Tax Bureau which consisted of six sections:

1. Estimated and Amended Tax Section
2. Central Filing and Typing Section
3. Compliance Section
4. Withholding Section
5. Collection Section
6. Audit Section

The Income Tax Bureau collected individual income taxes from three basic sources: (1) estimated tax payments; (2) withholding tax payments; and (3) tax payments accompanying individual income tax returns. During fiscal year 1974-75, the bureau collected revenues of $88,662,807 consisting of:

Withholdings	$62,324,766
Other*	26,274,601
Gubernatorial Campaign Contributions	63,215
Copy Fees	225
	$88,662,807

* Consists of estimated tax payments, income tax payments made at the time the tax returns were filed and other income tax receipts.

This portion of the report will first discuss general operations of the Income Tax Bureau, hereinafter referred to by its present title, the Income Tax Division, and then the operation of the specific sections.

Tax Return Processing Procedures

The basic individual income tax return processing procedures of the division consist of the following:

1. Tax returns are delivered to the division by the department's mail room personnel;
2. Cashier's numbers are assigned to non-remittance returns;
3. Audit coding personnel review returns for completeness;
4. Returns are keypunched and recorded on division computer files;
5. Standardized computer tests are performed on all returns with printouts called error resolution sheets summarizing discrepancies found;
6. Audit technicians and auditors review error resolution sheets making necessary adjustments and corresponding with taxpayers as necessary; and
7. Other audit tests are performed as problem areas become evident and as staffing allows.

The Estimated and Amended Tax Section and the Withholding Section receive periodic payments which apply towards the payment of individual income taxes. These sections are responsible for documenting such collections for use in verifying estimated tax and withholding tax payments claimed on individual income tax returns.

Procedures Manuals

The Income Tax Division has failed to institute written procedures manuals for any of its sections. Most section supervisors say they have not issued such manuals because of the time needed to prepare and maintain them.

Because of the complex income tax laws and related division procedures, it is essential that employees clearly understand what is expected of them. Such manuals are necessary for the training of new employees,

as well as for providing the present staff with a ready reference for questions that arise in their work. Without such manuals, supervisors and fellow employees spend an excessive amount of time explaining procedures to new employees. Procedures manuals would also eliminate the problems of issuing individual memoranda which can be easily lost or forgotten.

Procedures manuals would strengthen the efficiency and effectiveness of the division by reducing employee errors and duplication of effort. Once such manuals have been established, it would be relatively easy to maintain them on a current basis.

RECOMMENDATION

We recommend that the department institute written procedures manuals for all sections and establish a system to maintain the manuals on a current basis.

Individual Income Tax Forms

Our review of the individual income tax forms and instruction sheets disclosed an error on the 1974 individual income tax return instruction sheets. Section 84-4914, R.C.M. 1947, requires individuals who receive gross income of more than $665 singly or $1,330 jointly to file returns. The 1974 individual income tax instruction sheet incorrectly listed these requirements as $720 singly and $1,445 jointly. Because of this error an undeterminable number of taxpayers whose gross income fell within the $665-$720 range singly or $1,330-$1,445 range jointly did not file individual income tax returns.

Because of frequent changes to Montana tax laws and the potential effect of errors on income tax returns and instruction sheets, it is essential that the division establish adequate income tax form review

procedures to insure compliance. The Legal Division would be an excellent source of assistance in the review process.

The adequacy of individual income tax forms and instructions can greatly affect the efficiency and effectiveness of the division. If the forms are not clear and concise, resulting taxpayer errors can be excessive and require correction before other returns can be audited.

Our review of a sample of 130 individual income tax returns disclosed numerous taxpayer errors which seemed to result from inadequate or unclear forms and instructions. For instance, the 1974 income tax instructions did not include an explanation of estimated tax requirements. Thirteen of the 15 returns (87 percent) in our sample which should have reported estimated tax payments did not. The division remedied part of the problem by providing adequate explanations of the estimated tax requirements in the 1975 individual income tax instructions. The loss of estimated tax revenue to the state is discussed on page 32.

The estimated tax section supervisor identified another problem which results because taxpayers fail to submit the needed estimated income tax declaration (Form ES-2) with income tax returns which direct the department to credit overpayments of estimated tax to the following year. The requirement to submit this form is not documented on the tax return or instruction sheet. Rather than requesting that all such taxpayers prepare the ES-2's, the estimated tax section personnel complete the forms for filing in that section. By properly documenting this requirement, the estimated tax section would be better able to use this time reviewing filed returns.

Another area of inadequate documentation relates to child care deductions. Montana follows the federal income tax guidelines that

allow married taxpayers to deduct child care deductions only if they file joint returns. A problem results because it is generally beneficial for Montana married couples to file separate returns, and the Montana income tax forms and instructions do not specify that the child care deduction can only be claimed on joint returns. As a result, approximately 1,350 couples incorrectly claimed the child care deduction on separate returns for the 1974 tax year. The division has a special computer test which reviews all taxpayers within certain "Other Deductions" limits for this discrepancy. The costs of running these tests and following up on discrepancies could be decreased if taxpayers received adequate instructions.

Other problem areas relate to inadequate explanation of: (1) tax filing deadline extensions; (2) exemptions for institutionalized dependents; (3) estate and trust return requirements; and (4) how to handle federal income tax refunds on the state return.

RECOMMENDATION

We recommend that the department institute adequate individual income tax return review procedures to insure adequacy of instructions and compliance with state statutes.

Toll Free Taxpayer Assistance Telephone Lines

The division has no field offices or toll free statewide information telephone lines; therefore, taxpayer assistance is available only by mail, long distance calls (except for Helena and vicinity residents) or personal visits to the division's offices in Helena.

The division administrator said that the division receives 100-200 local and long distance calls daily for taxpayer assistance during the

tax season. The calls come to all sections of the division as well as the department director's office. At present, no one staff member is assigned responsibility for handling such calls. Whoever answers the phone tries to answer the question, and if unable to do so, the call is usually referred to one of the division's audit staff members.

Because many of our sample return errors resulted from the ambiguities and misinterpretations of individual income tax statutes, forms and instructions, we believe two incoming toll-free lines are essential during the tax season from January through April. The Internal Revenue Service has been using toll-free lines and has found them to be an excellent method of providing taxpayer assistance.

Toll-free lines, which cost approximately $695 per month each, will insure better taxpayer compliance, decrease the number of returns requiring audits, centralize with experienced personnel the responsibility for answering all questions, and free other division staff members to carry out their normal work as well as provide a service to the public. More taxpayers would also request assistance if such lines were available.

RECOMMENDATION

We recommend that the department provide two toll-free taxpayer assistance telephone lines during the months of January through April.

Data Processing Procedures

The division maintains computer files of all individual income tax returns for each tax year. These files include most of the information listed on each return and provide a basis for various return reviews

conducted by the division's audit section as well as statistical information prepared by the Research Division.

During fiscal year 1974-75, the Department of Administration's data processors keypunched tax return information on computer cards. These computer cards were processed to create the master file.

The initial computer review is an error resolution test which identifies returns with predetermined characteristics and errors. Audit technicians or auditors review and adjust all such returns.

Our review of error resolution printouts showed that a serious problem resulted because a majority of the keypunching was not verified--a manual comparison of the return and computer card by another keypuncher. Thirteen percent of the returns reviewed had error resolution sheets resulting from keypunch errors. A projection of this 13 percent rate to the estimated 322,500 individual tax returns received in fiscal year 1974-75 shows that approximately 45,800 returns could have error resolution sheets caused by keypunch errors.

These errors weakened the efficiency and effectiveness of the division because: (1) the audit staff spent too much time correcting keypunch errors rather than auditing returns; and (2) computer files remain permanently in error because auditors often by-pass normal correction procedures.

The audit section supervisor stated that the review time for each error resolution sheet could range from 5 minutes to 4 hours depending upon the type of error. By using a 15 minute interval per return for comparative purposes, the amount of unnecessary time spent by audit section personnel in correcting keypunch errors could range to approximately 11,000 man-hours. This time could be better utilized in the review of other returns selected on specific audit criteria.

The Income Tax Division administrator stated that additional verification was not done because of the high cost of verification and the fact that the keypunchers were unable to handle additional verification during peak activity periods.

Effective January 1, 1976, the department assigned the responsibility of keypunching and verifying all personal income tax information to its own Data Processing Division. By January 10, these procedures had proved unworkable because the verification process could not keep pace with the large number of returns being received. As a result, the division is now requiring only the verification of the social security number and cashier's number.

We believe that keypunch verification is essential unless the department can lower its error rate to a satisfactory level by other means. If necessary, the Data Processing Division should hire additional keypunchers on a temporary basis so that verification can keep pace with returns being processed during peak periods.

RECOMMENDATION

We recommend that the department lower its keypunch error rate by requiring verification of all information keypunched into the individual income tax computer files or by alternative procedures.

CENTRAL FILING AND TYPING SECTION

The central filing and typing section is responsible for the control of all individual income tax returns submitted to the division. It also maintains file indexes, storage areas, and accounts receivable records resulting from tax returns not including full payment.

Individual Income Tax Return Security

Section 84-4931, R.C.M. 1947, prohibits any officer or employee of the department from divulging the information contained on tax returns in any manner. The division's security procedures do not adequately safeguard against disclosures of individual income tax information.

Incoming individual income tax returns received from the mail room go through an initial review process and are then filed in the division's "block room". All returns for the tax year currently being processed and the preceding tax year are filed in the block room when not being reviewed or audited.

The block room area consists of two adjoining rooms with two exits and a separate room with a single exit. Although two personnel from the central filing and typing section normally work in the block room, they cannot observe all block room exits which are normally unlocked during working hours.

Tax returns being processed by division personnel are spread throughout the entire division work area and can be found on desk tops or in routing baskets awaiting further action. Most in-process returns are not secured at night except for the locks on office doors.

Although the division has only authorized selected personnel to enter the block room, present security procedures permit all division personnel access to the block room. The person removing a return is supposed to complete and place an "out" card in the space normally occupied by the tax return, but there are no controls to insure compliance.

Janitorial personnel have master keys which provide access to all division work areas including the block room after normal working hours. These personnel could readily access confidential information or remove

returns without the knowledge of division personnel. Several offices within the capitol complex, including the offices of the State Auditor and the Secretary of State, have janitorial workers do cleaning work in restricted areas during office hours to provide better control over records. The department could request the same type of service for the block room.

RECOMMENDATION

We recommend that the department:

1. *Require in-process returns to be locked in file cabinets after normal working hours.*
2. *Limit access to the block room at all times with central filing and typing section personnel assigned the responsibility of pulling, signing out and re-filing returns for other division employees.*

COMPLIANCE SECTION

The compliance section, which consists of the section supervisor, one technician and three clerk-typists, is responsible for insuring taxpayer compliance with Montana individual income tax laws. In order to fulfill this responsibility, the section carries out the following activities:

1. audits of delinquent and amended tax due returns;
2. detection of taxpayers who are not complying with Montana individual income tax statutes; and
3. in-office collection work and correspondence regarding assessments of additional taxes.

Information from sources such as the Montana Fish and Game Department, the Internal Revenue Service and annual information returns play an important part in these compliance review procedures.

IRS Information Computer Tapes

Annually, the compliance section obtains from the Internal Revenue Service computer tapes of Montana residents who file federal tax returns. A comparison of these tapes with the Income Tax Division's computer files enables the compliance section to determine those Montana residents who filed a federal return but failed to file a Montana individual income tax return.

The compliance section has failed to perform these comparisons on a timely basis. Comparisons for tax years 1971 through 1974 were not completed until February 1976. The division administrator related that the delays resulted because of computer programming staff shortages and the lack of funding for the comparisons once the programs had been developed.

It is essential that these comparisons be completed on a current basis so the compliance section can successfully follow up discrepancies. Many taxpayers move about extensively, and the longer the delay in making the comparison, the less likelihood there is of contacting them and collecting taxes from them. The problem of inadequate funding and programming staff must be evaluated as part of the department's budget process.

RECOMMENDATION

We recommend that the department make comparisons with IRS information computer tapes on a current basis to insure prompt follow up of discrepancies.

Compliance Section Staff

During our review of the compliance section, it became evident that many present and potential sources of information relating to taxpayer compliance are not being fully utilized because of a shortage of staff members.

The unused sources include: (1) numerous federal match cards resulting from the comparison of the IRS and Montana individual income tax computer files discussed in the preceding section; and (2) numerous information returns submitted to the compliance section from sources such as banks and savings institutions. To maximize potential collections the section staff only reviews information sources which report income exceeding specified levels.

Compliance section work is important because it promotes taxpayer compliance with income tax laws and instructions, as well as provides increased revenues. The division must evaluate staffing needs in the compliance section to maximize compliance coverage while still providing adequate revenue to justify any additional staff.

RECOMMENDATION

We recommend that the department re-evaluate the compliance section staffing level.

COLLECTION SECTION

The collection section consists of the section supervisor, one administrative assistant, one collector and two clerk-typists and is responsible for the collection of delinquent individual income and withholding taxes. In fulfilling this responsibility the section

corresponds with delinquent taxpayers and takes legal action authorized by Montana law when the taxpayer refuses to pay the amount due.

Collection Field Work

At the present time, the collection section does not have an effective field representative to personally contact delinquent taxpayers, which results in a probable loss of tax revenue. A field representative previously assigned to the collection section was lost in a reorganization to the Investigation Division. At that time, an agreement was made with the Investigation Division whereby its investigators would do collection section field work.

This agreement has not worked well because: (1) some field situations require technical tax knowledge not possessed by the investigative staff; (2) the Income Tax Division will not allow the investigators to take tax files into the field; (3) investigators are not directly responsible to the collection section in collection matters; and (4) Investigation Division priorities do not always coincide with those of the collection section. Based on comparisons of collections made during years when the collection section did and did not have a full-time field collector, we estimated that the department is losing approximately $134,000 in collection revenue each year because of these problems.

Because field contact is such an important part of a collection program, it is essential that these two divisions strive to correct the previously mentioned problems. If this is not feasible, the field position transferred to the Investigation Division should be returned to the collection section.

RECOMMENDATION

We recommend that the department insure that the collection section has adequate field collection support.

ESTIMATED AND AMENDED TAX SECTION

The estimated and amended tax section is responsible for the administration of Montana statutes and Income Tax Division policies concerning estimated taxes and the review for propriety of amended returns submitted to the Income Tax Division. More specifically, the estimated and amended tax section maintains estimated tax records, audits returns claiming estimated tax payments and amended returns, corresponds with taxpayers, and arranges for the collection of related taxes.

Estimated Tax Compliance and Penalties

Montana is one of 37 states that have estimated tax payment requirements. Thirty-one of these states, including Montana, have penalty provisions for underpayment of estimated taxes. The federal individual income tax statutes also provide for installment payments of estimated taxes and penalties for underpayment.

Section 84-4939, R.C.M. 1947, requires all taxpayers except farmers, ranchers and stockmen to declare and pay estimated tax when their net income from sources other than wages, salaries and bonus can reasonably be expected to equal or exceed net income subject to withholding tax, after deducting tax deductions and exemptions.

Our review of 130 returns showed that many taxpayers are not complying with the estimated tax requirements. Thirteen of the fifteen returns which should have reported estimated tax payments did not do so.

Based on a statistical projection of the ten percent sample exception rate, we estimate that approximately 35,900 individual tax returns submitted during fiscal year 1974-75 should have included documentation of estimated tax payments but did not.

Because of this non-compliance, the state lost the opportunity to use or earn interest on estimated taxes from the estimated tax due dates until the April 15 filing date. Although we cannot estimate the actual dollar loss, the large number of taxpayers failing to comply emphasizes the problem.

The department has taken the position that Section 84-4924, R.C.M. 1947, does not give the division the authority to penalize taxpayers failing to comply with estimated tax requirements. As a result, the department has no effective procedures to determine which taxpayers failed to declare and pay estimated tax or to penalize those taxpayers who failed to pay the tax.

The division has the general authority to penalize taxpayers not complying with estimated tax requirements. Section 84-4924, R.C.M. 1947, specifically provides in part:

> "If any person ... fails to pay any tax on or before its due date ... there shall be added to the tax a penalty of ten per cent (10%) of said tax ... and interest shall accrue on the tax at the rate of nine per cent (9%) per annum for the entire period it remains unpaid."

As the estimated tax is a tax due under the income tax laws, the penalty provisions of Section 84-4924, supra, should be applied. Enforcement of this penalty will assist the division in collecting all revenue due the state.

Under the present division procedures there are definite inequities between salaried individuals and wage earners and persons not subject to

income tax withholding. While the withholding tax requirements are strictly enforced, estimated tax requirements are loosely enforced. Wage earners required to pay withholding tax must pay their tax in advance, while taxpayers required by statute to pay estimated tax do not have to do so because there is no enforcement of the requirement and no assessment of penalty and interest for not complying with the law. Since many Montana taxpayers are already paying estimated tax to the federal government, compliance with the Montana laws is not an unreasonable requirement.

RECOMMENDATION

We recommend that the department:

1. *Establish effective procedures to determine which taxpayers failed to properly declare and pay estimated tax.*
2. *Assess penalties in accordance with Section 84-4924, R.C.M. 1947.*

WITHHOLDING SECTION

The withholding section is responsible for insuring employer compliance with Montana withholding statutes. The section maintains withholding records for approximately 20,000 Montana employers who submit: (1) quarterly withholding reports (Form MW-5) and payments; (2) annual withholding reconciliations (Form MW-10); and (3) employee withholding statements (Form W-2). Our audit tests disclosed many problem areas which will be discussed separately.

Follow-up on Delinquent Employers

The withholding section has a computerized system which prepares quarterly withholding reports (MW-5's) for mailing to all registered

employers for completion. This system was also originally designed to generate delinquency notices for employers who failed to complete and return these MW-5's by the statutory deadline. The mailing of delinquency notices was suspended during fiscal year 1974-75 because of computer processing problems resulting in notices being sent to inactive employers or employers who had already paid the required withholding tax.

There are numerous employers on the withholding section's receipt summaries which show no withholding reported or paid for part or all of the 1974 and 1975 tax years. Inactive employers should be deleted from the MW-5 mailing list, and those active employers not complying with delinquency notices should be audited so the amount due can be determined and collected with appropriate penalties.

The section is presently working to correct this computerized system so that it will generate proper delinquency notices, but this portion of the system is not yet operational. It is essential that this system be implemented so that inactive employers and employers who fail to submit timely withholding reports are identified for further follow-up.

RECOMMENDATION

We recommend that the department:

1. *Revise the withholding delinquency notice system to properly notify employers who fail to meet withholding reporting deadlines;*
2. *Remove inactive employers from mailing lists for quarterly withholding reports (MW-5's); and*
3. *Follow-up promptly on employers not complying with withholding delinquency notices.*

Late Filing of Annual Withholding Reports

Section 84-4950, R.C.M. 1947, requires employers to file an annual reconciliation of withholding tax payments (Form MW-10) and employee withholding statements (Form MW-2) by February 15 of the following year. Sections 84-4924 and 84-4954, R.C.M. 1947, provide a penalty for late filing of these forms.

The withholding section has failed to assess these penalties against applicable employers. The withholding section supervisor gave two reasons for this non-compliance: (1) inadequate staffing; and (2) lack of administrative support for filing of warrants for distraint, since the department's position is that legal authority to penalize employers does not apply to Form MW-10. We have estimated that, as a result of this non-compliance, the withholding section lost a minimum of $8,300 in penalties for the 1974 tax year.

The withholding section must have the necessary staffing and administrative support required to comply with Montana law to ensure timely reporting of state income tax withheld by Montana employers.

RECOMMENDATION

We recommend that the department assess penalties for failure to file timely MW-10's and MW-2's in accordance with Sections 84-4924 and 84-4954, R.C.M. 1947.

Office Audit Procedures

The withholding section reviews records submitted by employers after receipt of the annual withholding reconcilation report (Form MW-10) for each employer. The review is basically designed to disclose any

discrepancies such as missing quarterly reports, no record of withholding payments claimed, etc.

During fiscal year 1974-75 this review was only partially completed with no action taken on those discrepancies discovered as of our report date. The section supervisor said that because of inadequate staffing he had not been able to complete the review or follow-up on these discrepancies.

While the review procedures themselves are adequate, the failure to complete the review and follow-up on any discrepancies is a serious problem. This review is essential to ensure employer compliance, and if adequately followed up, would generate additional tax revenue.

RECOMMENDATION

We recommend that the department complete a timely review of employer withholding records on an annual basis after receipt of the annual withholding reconciliations (Form MW-10) and follow up discrepancies noted.

Employer Payroll Field Audits

The withholding section does not perform any field audits of Montana employers to insure their compliance with state withholding requirements. In a few problem cases auditors from the Income Tax Division audit section have done some field audit work for the withholding section, but few employers' payroll records are audited for withholding compliance. As a result, the withholding section depends upon the integrity of the applicable employers for compliance with withholding requirements.

Our field review of 65 employers showed that the current procedures are not adequate. We found 6 employers who should have been withholding taxes from their employees, but did not do so; 2 employer payroll errors; and numerous withholding rate errors. In those cases where the withholding tax is not paid or is paid at other than the required rate, the state loses the right to use or earn interest on the unpaid amount from the withholding due date until the individual income tax return filing date. Additionally, the state must depend upon individual employees to properly report earned income if no withholding is made.

It is essential that the withholding section implement a field audit program to review employers' payroll records on a periodic basis. This will enable the section to identify problem employers and procedural problems requiring review, as well as generate additional tax revenue.

The Employment Security Division and the Workers' Compensation Division have operations dealing with Montana employers and their payrolls as does the withholding section. Both agencies assign identification numbers to employers under their jurisdiction, collect payments from the employers periodically based on specified rates per dollar of employee gross pay, and conduct periodic audits of employer payroll records. The Employment Security Division has a staff of eleven field auditors who visit approximately 2,000 employers each year. The Workers' Compensation Division has a staff of eight field auditors who visit approximately 400 employers each year.

Montana would benefit from a coordination of the employer related operation of these two divisions and the Montana withholding section. A coordinated audit effort, with the three agencies performing audit

work for each other, would prevent audit duplication and provide greater audit coverage for each agency. Audit costs should also decrease per employer visited since travel costs would be cut by two-thirds for a visit to the same employer. Additionally, Montana employers would directly benefit by dealing with one set of auditors rather than three.

We used such a coordinated audit effort to test employer compliance as part of our audits of the Department of Revenue and the Employment Security Division. We encountered no problems and were able to decrease the audit and travel time that would have been required if we had tested two separate employer samples.

We believe that once a withholding field audit program has been designed, the department should work with the Montana Department of Labor and Industry on the possible coordination of employer identification numbers and audit activity. Although the coordination of efforts must be carefully planned and auditors must be educated in each agency's laws and regulations, Montana state government and Montana employers would benefit from such coordination of effort.

RECOMMENDATION

We recommend that the department:

1. *Implement a withholding field audit program to review Montana employer compliance with state withholding requirements; and*
2. *Work with the Montana Department of Labor and Industry in coordinating employer audit programs to insure maximum employer compliance at a minimum of inconvenience to employers.*

AUDIT SECTION

The audit section consists of the section supervisor, nine auditors, two technicians, six clerks, one part-time worker, and eight to nine temporary workers. Temporary workers are employed only during the peak tax season, and their number varies with the daily work load.

The audit section is responsible for insuring taxpayer compliance with Montana individual income tax laws and regulations. This responsibility is fulfilled through computer testing of return information and auditing returns which meet audit criteria established by the audit section supervisor. The section also has a limited field audit program. The audit section maintains all correspondence with taxpayers that is necessary to reconcile discrepancies between tax returns and Income Tax Division requirements.

Withholding Tax Audit Procedures

The audit section does not, as a normal routine, compare employee withholding statements (Form W-2) submitted to the withholding section by employers, with W-2's submitted by taxpayers with their individual income tax returns. The audit staff performs this test on less than 5 percent of the returns. By failing to perform such a test on a regular basis, the division has inadequate controls to prevent:

(1) employers from withholding taxes and issuing W-2's to employees, but not reporting or paying the withheld taxes to the withholding section;

(2) taxpayers from submitting falsified W-2's which could result in improper tax levels or refunds;

(3) taxpayers from failing to report all income on returns as reported by their employers to the withholding section.

In a sample comparison of 114 W-2's received in the withholding section with W-2's submitted with individual income tax returns, we found five taxpayers who should have submitted a state return including the sample W-2, but did not. We also found four taxpayers who filed a state return but failed to include the wages reported on the sample W-2. Since three of the five taxpayers not submitting a state return also did not file a federal return, the federal match discussed on page 29 will not detect these exceptions.

Under present procedures, a complete comparison could be costly since all W-2's submitted would have to be keypunched for computer comparison. The cost must be compared with the resulting benefits. If the cost is excessive, the division could make the comparison on a sample basis. This test is essential to ensure employer and taxpayer compliance.

RECOMMENDATION

We recommend that the department study and select a feasible procedure for comparison of W-2's submitted by employers and taxpayers to ensure compliance with Montana statutes.

Field Audit Procedures

Review of returns selected for further examination is normally done within the audit section's offices. The usual methods of soliciting information and records necessary for audits consist of correspondence and telephone calls. The section has no field offices, and field work is done on a very limited basis. In fiscal year 1974-75, for example, the audit section completed 80 field audits and six information gathering projects.

The division places much reliance on the Internal Revenue Service's compliance and enforcement program to perform the same function for the Montana income tax system. The IRS supplies two basic types of information: (1) revenue agent reports (RAR's); and (2) a computer tape of all federal filings received from Montana residents. This reliance on the federal program is justified to a certain extent, but the state can effectively supplement this program with the development of an improved state field audit program.

Based on our audit experience, we believe that the lack of direct contact with the taxpayer and his supporting records severely restricts the effectiveness of tax return audits. While a large number of reviews can be handled without personal contact, more complex returns require direct contact and access to the taxpayer's records for an adequate review. Currently, field auditors are collecting approximately $11 for every $1 of audit cost.

The limited scope of the audit section field audit program is also partially due to a shortage of auditors available to perform field work. Although several new auditors joined the staff in 1975, the development of an improved field audit program may require further additions to the audit section staff.

RECOMMENDATION

We recommend that the department expand its individual income tax field audit activities to provide adequate review of taxpayer compliance.

Audit Test Documentation

The audit section does not adequately document the type of tests performed on reviewed returns or related working papers. The audit section auditors do not initial returns they review or note the type of tests performed on them. The section supervisor stated his auditors were not required to do this because they are "professionals".

Although the return file will include any correspondence or related review results, the additional identification of reviews performed would increase the efficiency of audit procedures by preventing duplication of audit effort. Identification of the auditor performing the review will give employees incentive to be more careful in their work as well as provide ready reference to the proper auditor if questions should arise on a particular return.

During fiscal year 1974-75, there was also little documentation of field audit work performed by the audit section. Most documentation consisted of notes written on related returns. As such, there were no working papers summarizing work done and audit results.

Field audits represent an important part of the audit section's audit responsibility and should be well documented for review by supervisors, as well as provide documentation of prior action if additional questions arise concerning an audited taxpayer.

RECOMMENDATION

We recommend that the department require adequate documentation of individual income tax return tests and field audit work completed.

Tax Compliance Enforcement

Section 84-4924, R.C.M. 1947, clearly defines the penalties to be assessed taxpayers who fail to meet individual income tax requirements. During our review of the collection section, it became apparent that the department has failed to meet the mandate requiring it to penalize taxpayers for not properly filing individual income tax returns and paying related taxes.

We reviewed 25 collection files pertaining to taxpayers who failed to submit individual income tax returns over a period of years and which files are currently being worked for payment by the collection section. Several examples listed below document circumstances and action taken by the Income Tax Division:

Taxpayer A--This individual did not file tax returns for 1962 through 1973, so the Income Tax Division estimated his total taxes due of $756. The taxpayer claims he filed returns in other states but filed federal returns from a Montana address. The Collection Section has corresponded with the taxpayer and has filed warrants for distraint, but to date none of these taxes have been collected. No penalty or prosecution has been initiated for tax evasion.

Taxpayer B--The IRS informed the Income Tax Division in 1971 that this individual had not filed a federal or Montana return for 1963 through 1969. The division estimated his taxes due and has sent numerous letters and filed warrants for distraint. The taxpayer has made irregular payments of $50-75 per month. The current balance due is approximately $6,500. No penalty or prosecution has been initiated for tax evasion.

Taxpayer C--This individual did not submit returns from 1957 through 1966. The 1967 through 1969 returns were delinquent, and the Income Tax Division estimated his taxes due and issued warrants for distraint and levies on bank accounts. The individual is currently paying $50 a month with a balance due of approximately $17,000. The IRS did prosecute in relation to federal tax, but no state penalty or prosecution has been initiated for tax evasion.

These examples and many of the others reviewed seem to justify prosecution for tax evasion. A person does not accidentally forget to file tax returns for a number of years as documented in the three examples above.

We did not find a single case where the Income Tax Division either assessed the penalty or sought prosecution for tax evasion. The division administrator acknowledged that no individuals have been prosecuted for evasion of taxes during recent years.

It is essential that the division assess penalty and interest as well as seek prosecution of apparent tax evaders. The application of the 25 percent penalty and 1 percent monthly interest charge would provide a further deterrent against future occurrences.

RECOMMENDATION

We recommend that the department assess appropriate penalties and interest and seek prosecution against apparent tax evaders as required by Section 84-4924, R.C.M. 1947.

CORPORATION TAX DIVISION

The Corporation Tax Division is responsible for administration of Montana corporation license and income tax laws. For fiscal year 1974-75, the Corporation Tax Division reported collecting tax revenues totaling $22,078,581.

The corporations under the jurisdiction of the division fall into three basic categories:

1. Small business corporations.
2. Domestic corporations.
3. Multi-state corporations.

The small business corporations must file elections to be considered such an organization, file annual returns documenting distribution of corporate income to individual stockholders and pay a $10 filing fee each year. The department considers domestic corporations as those corporations organized and doing business only in Montana. The multi-state corporations are those corporations organized in any state and doing business in Montana and other states.

Return Review Procedures

The division's auditors normally review all returns submitted by corporations. Basically this review consists of footing schedules and return amounts and making checks in special areas such as bad debt allowances, contributions and apportionment. If a discrepancy exists, the auditor will correspond with the corporation to obtain needed information. This is the only review normally conducted on small business and domestic corporations. These review procedures are also used in selecting potential multi-state corporations for audit.

During our review of a sample of 122 corporation tax returns, we found seven returns which included no documentation that this review was completed. We also found 25 exceptions which should have been disclosed by these review procedures.

Since this review is the only work done on small business and domestic corporations, it is essential that the review be thorough and complete.

RECOMMENDATION

We recommend that the department require strict adherence to its corporate tax return review procedures.

Taxation of Inactive Corporations

Section 42-2.6(1)-S6580 of the Montana Administrative Code states that the minimum corporation license tax ($50 for all except small business corporations, which must pay $10) is not assessable against inactive corporations. The division has failed to comply with this regulation.

The division administrator believes that Montana statutes are unclear as to taxation of inactive corporations. He acknowledged that the division's current policy is to keep the money sent it by inactive corporations unless a refund is requested, but not to solicit payments from inactive corporations not sending in such a remittance.

While Section 84-1501, R.C.M. 1947, is unclear, Section 42-2.6(1)-S6580 of the Montana Administrative Code clearly specifies that inactive corporations need not pay the minimum corporation license tax. The division must comply with this requirement and accordingly inform inactive corporations.

While we did not determine the total amount of such collections, we found $300 of unauthorized collections in our corporate tax return sample. The division is liable for the refund of these unauthorized collections, even if the applicable corporations do not request a refund.

RECOMMENDATION

We recommend that the department refund minimum corporation license tax payments received from inactive corporations in compliance with the Montana Administrative Code.

Bad Debt Expense Deduction

Section 84-1502, R.C.M. 1947, states that only the bad debt losses actually sustained and charged off within the year and not compensated for by insurance shall be allowed as deductions from gross income received by a corporation. The division is not complying with this statute because it has adopted the informal policy of allowing the deduction of a reasonable estimate of bad debt expense at the discretion of the auditor reviewing a return.

In our corporate return sample, we found two corporations which were allowed to improperly deduct a total of $6,800 in estimated bad debt expense. As a result, the total gross income of these corporations was understated by $6,800. Any direct writeoffs would offset these amounts.

Part of the problem is the fact that this Montana law is not consistent with the federal corporation tax law which allows the deduction of estimated bad debts. Many corporations complete their Montana corporation tax returns by copying information directly from the federal returns, and as a result, estimated bad debts may be included on their Montana return.

While this procedure may be convenient for the corporation, it should not be allowed without a change in the Montana statute. Unless the statute is changed, the division should disallow such deductions to insure maximum tax revenue.

RECOMMENDATION

We recommend that the department disallow the deduction of estimated bad debts in compliance with Section 84-1502, R.C.M. 1947, or seek legislation allowing a deduction which conforms with federal tax law.

Accounts Receivable Adjustments

Staff auditors make all individual accounts receivable credit adjustments (decreases) they have generated as a result of their audits. The division does not document any review of these credit adjustments.

Adequate internal control would require a documented review of accounts receivable adjustments by supervisory personnel to insure that such adjustments are proper. Under the present procedures, an auditor could decrease accounts receivable balances as a personal favor for the applicable corporation. Documented review procedures would insure that credit adjustments were appropriate and would guard against illegal activities. Because of the small number of accounts receivable, the division administrator should be able to document the review of all such adjustments.

RECOMMENDATION

We recommend that the department adequately document supervisory reviews of corporate tax accounts receivable credit adjustments.

Field Audit Procedures

During fiscal year 1974-75 the division performed field audits on 27 multi-state corporations. The field audits normally take about a week per corporation and are performed by a team of two auditors. These audit teams usually travel for two to three-week periods and schedule audits within the same geographical area.

During these audits, auditors follow general division guidelines as to special interest areas and audit working paper procedures. The division does not include formal audit programs in its field audit working papers. After completing their audit trips, the auditors spend additional office time completing necessary supporting documentation and writing an audit report for management.

While the working paper files and audit reports we examined were reasonably well-documented, we believe it is essential that an audit program be included in the field audit working papers. An audit program would better document audit requirements as well as insure that all required tests were completed. This program should outline those audit areas and tests common to all field audits. The audit supervisor should then add additional tests relevant to the corporation being audited. The program should include working paper references and should be signed by the auditor completing the work.

RECOMMENDATION

We recommend that the department include a written audit program in all corporate tax field audit working papers.

Audits of Small Business and Domestic Corporations

The division does not perform field audits of any small business or domestic corporations--those incorporated and operating only in Montana. The division only performs an in-office review, for mathematical accuracy and completeness, of returns submitted by these corporations.

Presently the division only audits the larger foreign corporations because of its emphasis on the greatest dollar return for audit work completed. The division depends on the IRS to perform audits of small business and domestic corporations.

The emphasis on the greatest dollar return has one serious disadvantage. This is the fact that the division is not testing small business and domestic corporations for compliance with Montana regulations. Under present procedures, these corporations can submit any information, and as long as the tax return is complete and totals properly, there is no prospect of an audit by the division.

In order for the division to properly enforce corporation tax laws, it must audit small business and domestic corporations on a sample basis.

RECOMMENDATION

We recommend that the department audit small business and domestic corporations to insure compliance with Montana regulations.

PRIOR RECOMMENDATIONS

The department has fully complied with eight recommendations and partially complied with two of the 12 recommendations applicable to the Income Tax and Corporation Tax Divisions in two audit reports issued by this office on the department for fiscal year 1967-68 and a follow-up review issued in September 1972. We discuss below the action taken to date on the four recommendations which have not been fully implemented.

Recommendation: Establish a system of comparing state income tax withholding amounts per withholding statements submitted with tax returns to those submitted by employers, at least on a test basis.

The department has failed to initiate an effective withholding statement review program. This recommendation occurs again on page 40 of this report.

Recommendation: Establish necessary procedures to facilitate the reconciliation of data processing totals for income tax collections to the cashier's totals by taxable year and reconcile these totals on a periodic basis.

The department's income tax data processing totals are still not reconciled with collections processed by the cashier section.

Recommendation: Require timely payments of taxes and assess the penalties and interest prescribed by law when payments are not made on time.

The department has failed to assess all penalties on taxpayers not meeting tax deadlines. Similar recommendations occur on pages 32, 36 and 44 of this report.

Recommendation: Consider the merits of revising the accounting and financial reporting system to break out and show separately the amount of penalties and interest collected by the type of tax.

The department continues to account for all normal income tax collections, penalties and interest as income tax revenue.

FINAL COMMENTS

We have reviewed the comments and recommendations contained in this report with the Director of the Department of Revenue and his staff. The full text of the department's response to this report begins on page 55.

We wish to express our appreciation to the Director and his staff for cooperation and assistance during this audit.

SCHEDULE OF INDIVIDUAL INCOME TAX AND CORPORATION LICENSE AND INCOME TAX REVENUES AND ACCOUNTS RECEIVABLE

Fiscal Year Ended June 30, 1975

DEPARTMENT OF REVENUE

SCHEDULE OF INDIVIDUAL INCOME TAX AND CORPORATION LICENSE AND INCOME TAX REVENUES FOR FISCAL YEAR ENDED JUNE 30, 1975

Income and Inheritance Tax Division	
Individual Income Taxes:	
Withholding	$ 62,324,766
Other	26,274,601
Gubernatorial Campaign Contributions	63,215
Copy Fees	225
Total Individual Income Tax Revenue	88,662,807
Corporation Tax Division	
Corporation Income and License Taxes	22,078,581
Total Income and Corporation Tax Revenue	$110,741,388

SCHEDULE OF INDIVIDUAL INCOME TAX AND CORPORATION LICENSE AND INCOME TAX ACCOUNTS RECEIVABLE AS OF JUNE 30, 1975

Income and Inheritance Tax Division	
Individual Income Tax Receivables	$ 854,289
Withholding Tax Receivables	295,199
Total Income and Inheritance Division Receivables	1,149,488
Corporation Tax Division	
Corporation Income and License Tax Receivables	1,403,528
Total Income Tax and Corporation Tax Accounts Receivable	$ 2,553,016

AGENCY REPLY

STATE OF MONTANA

DEPARTMENT OF REVENUE
MITCHELL BUILDING
HELENA, MONTANA 59601

UDITOR

September 10, 1976

Morris Brusett
Legislative Auditor
Capitol Building
Helena, Montana 59601

Dear Morris:

I am enclosing the Department's response to the recommendations which were made relative to operation of the Income Tax and Corporation License Tax Divisions. There are certain points with which I do not agree. Obviously there are many paths leading to each goal of the agency and it is only natural that reasonable men might find themselves at odds over which course of action is best. I have attempted to discuss the points of divergence in the accompanying response. Perhaps I have been too concise and, if this is the case, I would certainly welcome the opportunity to provide additional explanation.

I am sure that you are well aware of the personnel and budgetary limitations under which the two Divisions labor. It is my duty as Director to set priorities for operation of the Divisions in order to achieve optimal performance within these constraints. You may be assured that all recommendations will be evaluated and acted upon within the context of priorities I set.

I wish to commend the staff of the Legislative Auditor's Office for the professional behavior it exhibited during the audit. I appreciate the courtesy accorded to employees of the Department and the sincere effort with which the work was carried out.

Very truly yours,

Bill

W. A. GROFF
Director

DEPARTMENT OF REVENUE – RESPONSE

RECOMMENDATION:

We recommend that the Department:

1. Study and implement alternatives to the present tax receipts processing methods to minimize deposit delays.
2. Hire temporary staff or authorize overtime during peak periods to expedite the deposit of tax receipts.

RESPONSE:

We concur and will implement both recommendations, assuming that additional funding becomes available to hire the extra temporary staff recommended. The objective will be to cut the average time from receipt in the department to deposit in the treasury from 18 to 5 – 8 days during the income tax peak periods.

This might be done by increasing temporary staff from 8 to 24 people. However, this and additional efforts to speed up the deposit process by hiring more staff for a shorter period could be restricted by the job market and office space.

RECOMMENDATION:

Provide adequate security for unprocessed mail.

RESPONSE:

We concur. Secured storage space has been allocated to unprocessed mail and becomes available when the new addition to the Mitchell Building is completed.

RECOMMENDATION:

We recommend that the department make deposits with the state treasurer's office at the end of each work day to facilitate maximum investment earnings for the state.

RESPONSE:

We concur and will implement the recommendation. To make deposits with the State Treasurer at the end of each work day it will be necessary to make a noon cut-off in the cashier's office because other essential procedures are required after the cashiering process is complete.

RECOMMENDATION:

We recommend that the department: (1) Eliminate credit balances in accounts receivable, correct data entry errors, and revise computer produced reports to provide more meaningful information. (2) Automate pre-1974 individual income tax receivables to provide meaningful management information relating to these receivables. (3) Evaluate all present receivable systems and interface them with the statewide budgeting and accounting system and with each other. (4) Consider consolidating accounts receivable recordkeeping in the audit and accounting division to correct existing internal control weaknesses.

RESPONSE:

We concur and we either have implemented the recommendations or have always planned the inclusion of the recommendations in our accounts receivable system. The problems indicated by the legislative auditor were not serious problems but rather typical problems of getting any 'system' operational and the accounts receivable system was only being developed at the time of the legislative audit.

RECOMMENDATION:

We recommend that the department evaluate active and potential data processing systems to determine problem areas and obtain the capability to meet the needs of the department.

RESPONSE:

At the time the Department of Revenue was audited, the above recommendation was appropriate. In the months which passed between the audit interviews and release of the audit report, the data processing division did undertake such a review. As a result, the data processing systems for individual income tax and motor fuels special permits were redesigned. We are presently redesigning the liquor inventory and accounts receivable systems and anticipate beginning the redesign of the withholding tax and store license systems. Since the time of the audit interviews, the data processing division's staffing pattern and budget have stabilized. The division is therefore hopefully now better able to meet the needs of the department than it was at the time of the audit interviews. In summarization, at the time the interviews were carried out, the recommendation was appropriate and we concur with the recommendation.

RECOMMENDATION:

We recommend that the department disclose uncollectible accounts receivable on its financial statements in accordance with generally accepted accounting principles.

RESPONSE:

We agree that uncollectible accounts should be disclosed in the department's financial statements. When and as our account receivable systems become fully operational the uncollectible accounts will be transferred regularly to our bad debt collection section which will identify them as problem accounts and when they are definitely determined to be uncollectible they will be properly written-off. For the 1974-75 year, it should be pointed out that not all receivables were reported on the statements and no pre-1974 receivables were included as receivables. All receivables shown were fully reserved, i.e. they did not affect revenues or income.

RECOMMENDATION:

We recommend that the department's financial statements report known unpaid income tax refunds as payables and accordingly decrease reported tax revenues.

RESPONSE:

We do not concur with this recommendation. Reporting unpaid income tax refunds as payables and accordingly decreasing reported tax revenues represents a change in the current method of accounting prescribed for us by the statewide budget and accounting system (SBAS) which would not materially affect the department's financial statements except in the year of

the change, and would require establishing a system for identifying and determining the total claims filed as of June 30 each year that simply cannot be cost-justified.

Our reporting system is not unique to Montana, and other states using a similar method have been judged to conform substantially to the standards promulgated by the National Committee on Governmental Accounting.

RECOMMENDATION:

We recommend that the department establish procedures to insure compliance with small business corporation tax requirements.

RESPONSE:

We are in agreement in concept that the department should have procedures to insure compliance but are in disagreement to the comment that "the department makes no effort . . .". Shareholders of small business corporations are required to report the same amounts of corporate income on their Montana Individual Income Tax returns as they are to report on the Federal returns. The failure of a Montana shareholder of a small business corporation to either file a Montana return or to report his share of corporate income or loss would be disclosed via the matching process of the Federal and Montana income tax returns contained on magnetic tape. The matching process is completed through 1974, and inasmuch as 1975 tapes have not yet been received from the Federal Government the matching is current, which the auditor's point out on page 29 of the report. Since August, 1975, the income tax division has been receiving photocopies of returns filed by selected small business corporations having non residents shareholders. Additionally, the Internal Revenue Service audits returns of small business corporations and their shareholders. We receive and follow up on the abstracts of audit reports relative thereto, and adjust the Montana returns accordingly. Thus while an effort is made to insure compliance and while procedures are established, we will review the area to determine what improvements should be made, as we are aware that improvements are needed.

RECOMMENDATION:

We recommend that the department institute written procedure manuals for all sections and establish a system to maintain the manuals on a current basis.

RESPONSE:

We concur.

RECOMMENDATION:

We recommend that the department institute adequate individual income tax review procedures to insure adequacy of instructions and compliance with state statutes.

RESPONSE:

We concur. Clear instructions are beneficial to the taxpayer and to the department. We do point out that tax filing deadlines for extensions are adequately covered in the 1975 instructions and clear instructions for handling federal refunds on the state return have been covered since 1965, page 2, under "Federal Income Tax Refunds".

RECOMMENDATION:

We recommend that the department provide two toll-free taxpayer assistance telephone lines during the months of January through April.

RESPONSE:

We concur, and have requested the necessary funding to do so in the next biennium.

RECOMMENDATION:

We recommend that the department lower its keypunch error rate by requiring verification of all information keypunched into the individual income tax computer file, or by alternative procedures.

RESPONSE:

We concur. In fact, a new keypunch format was implemented in January, 1976, for the 1975-76 income tax season. The format lowered the error rate to one acceptable to the department, and one considerably less expensive than total key verification would have been.

RECOMMENDATION:

We recommend that the department.

(1) Require in-process returns to be locked in file cabinets after normal working hours.

(2) Limit access to the block room at all times with central filing and typing section personnel assigned the responsibility of pulling, signing out and re-filing returns for other division employees.

RESPONSE:

We concur with both recommendations. While full compliance with both presents some problems, e.g. lacking sufficient filing cabinets, remodeling the physical facilities, it is our objective to achieve full compliance.

RECOMMENDATION:

We recommend that the department make comparisons with IRS information computer tapes on a current basis to insure prompt follow-up of discrepancies.

RESPONSE:

We concur, and have been current since February of 1976.

RECOMMENDATION:

We recommend that the department re-evaluate the compliance section staffing level.

RESPONSE:

We concur, both with problems enumerated and the suggested recommendation to alleviate the problems. Our request to the Legislature for additional staffing for the 1976-77 biennium was denied. We are again requesting additional staffing for the 1978-79 biennium.

RECOMMENDATION:

We recommend that the department insure that the collection section has adequate field collection support.

RESPONSE:

We concur and will make an effort to provide better and hopefully adequate field collection support.

RECOMMENDATION:

We recommend that the department:

(1) Establish effective procedures to determine which taxpayers failed to properly declare and pay estimated tax.

(2) Assess penalties in accordance with Section 84-4924, R.C.M. 1947.

RESPONSE:

We do not concur with either of these recommendations. While we accept the concept that the recommendations imply, we believe the first to be pointless as we are of the position that we have no authority to assess penalties under the cited or any other section of the law.

The term 'tax' has a very distinct meaning under the law. It is the amount due on the basis of the taxpayer's return of income as required under section 84-4914. Section 84-4940(4) clearly distinguishes "estimated tax" payments from "tax" liability in stating "payments of estimated tax shall be considered payment on account of the tax for the taxable year." Accordingly, the term "tax" as used in the penalty provision does not include estimated tax payments. Had the Legislature intended that section 84-4940 apply to estimated tax it most certainly would have specifically so stated as it did in the case of all other provisions in the law requiring prepayment of tax liability.

Moreover, penalties for failure to pay estimated tax are imposed with respect to the amount of the underpayment for the period of the underpayment.

It would be unreasonable and unrealistic to assume an individual can estimate tax liability a year in advance with pinpoint accuracy. Accordingly, when estimated tax laws impose a penalty for underpayment they specifically define the term underpayment, usually in terms of a percentage of actual liability. They also normally provide for certain exceptions. A few estimated tax laws merely impose interest on the underpayment for the period it existed. The penalties set forth in section 84-4924 contain no such provisions.

Assume the 10% penalty were applied to underpayment of estimated tax. How close to actual tax liability must the estimated tax payment be in order for the taxpayer not to be penalized for underpayment? If a person owes $50,000 and paid only $45,000 in estimated tax, is it reasonable to impose the 10% penalty of $500 on the difference? Clearly, it would not be reasonable to do so, but where do we draw the line in the absence of specific statutory penalty provisions defining "underpayment"?

To be clear, we are not in opposition to estimated tax and proper penalty provision thereto. On the contrary, we believe that such should be the case in Montana. Our belief is that an enforceable estimated tax program should be very similar to that of the Federal Government, both in the way of exemptions and penalties. Wage earners already pay estimated tax through an enforceable withholding system. It would seem equitable that many non-wage earners should also be subject.

On three separate occasions the department sought and was successful in having legislation introduced which would apply specific penalty provisions for underpayment of estimated tax, and each time the Legislature overwhelmingly defeated the bills. This is reason alone for our position to be that the Legislature never intended the cited statutory authority to apply to estimated tax.

RECOMMENDATION:

We recommend that the department:

(1) Revise the withholding delinquency notice system to properly notify employers who fail to meet withholding reporting deadlines.

(2) Remove inactive employers from mailing lists for quarterly withholding reports (MW-5's); and

(3) Follow-up promptly on employers not complying with withholding delinquency notices.

RESPONSE:

We concur, and would add that when this area was reviewed, the problems were real, and some still are. However, the system, since inception and during the audit, had the capability to properly notify delinquent employers. As the auditors point out, the area still needs improvement and much has already been done.

RECOMMENDATION:

We recommend the department assess penalties for failure to file timely MW-10's and MW-2's in accordance with section 84-4924 and 84-4954, R.C.M. 1947.

RESPONSE:

The report does not specify which of the penalties believed to be applicable. Our assumption is that the reference is to 84-4924(3) inasmuch as the MW-2's and MW-10's are informational returns not involving a payment of tax, thus not applicable to a percentage penalty found in (1) and (2).

It is our position that the "information" referred to in section 84-4954 and 84-4924(3) has specific reference to fake and fraudulent information in an income tax form and not to a purely informational return. Assuming the validity of the auditor's position we believe that criminal penalties for failure to file informational returns deserves lower priority on available resources than seeking criminal penalties for failure to file actual income tax returns.

In sum, we do not believe that legislative intent was to apply the rather severe criminal penalties of section 84-4924(3) to pretax, i.e., informational returns.

RECOMMENDATION:

We recommend that the department complete a timely review of employer withholding records on an annual basis after receipt of the annual withholding reconciliations (Form MW-10) and follow-up discrepancies noted.

RESPONSE:

We concur

RECOMMENDATION:

We recommend that the department:

(1) Implement a withholding field audit program to review Montana employer compliance with state withholding requirements; and

(2) Work with the Montana Department of Labor and Industry in coordinating employer audit programs to insure maximum employer compliance at a minimum of inconvenience to employers.

RESPONSE:

We concur. Implementation of the recommendation will be directly dependent on available funding, but we are in agreement with the auditor that the program is needed. The "auditing in concert" concept appears to be workable from our standpoint.

RECOMMENDATION:

We recommend that the department study and select a feasible procedure for comparison of W-2's submitted by employers and taxpayers to ensure compliance with Montana statutes.

RESPONSE:

We concur. Preliminary reviews indicate that cost is excessive and that a sample basis approach would appear to be the more practical method.

RECOMMENDATION:

We recommend that the department expand its individual income tax field audit activities to provide adequate review of taxpayer compliance.

RESPONSE:

We concur, and have attempted in the past to secure additional auditor positions with only fractional success. We have again requested funds in the coming biennium for additional field auditors.

RECOMMENDATION:

We recommend that the department require adequate documentation of individual income tax return tests and field audit work completed.

RESPONSE:

We concur. This should be done as a matter of normal procedure. Adequate documentation is a must when additional assessments are determined, when issues are in dispute and hearings are held, and in many other circumstances.

RECOMMENDATION:

We recommend that the department assess appropriate penalties and interest and seek prosecution against apparent tax evaders as required by section 84-4924, R.C.M. 1947.

RESPONSE:

We concur with the recommendation. Our efforts in this area have been less than satisfactory. However, our effort to implement the recommendation may be less diligent than the auditor may want from the implications in the report. The examples A and B were both cases where we lacked evidence of intent to defraud, thus making it rather difficult to initiate prosecution. While we readily agree that it is important to seek prosecution in given cases, the establishing of intent is very difficult. Failure to file does not establish intent in and of itself, nor does it prove a case of tax evasion.

RECOMMENDATION:

We recommend that the department require strict adherence to its corporate tax return review process.

RESPONSE:

We concur.

RECOMMENDATION:

We recommend that the department refund minimum corporation license tax payments received from inactive corporations in compliance with the Montana Administrative Manual.

RESPONSE:

We concur. The unauthorized collections will be refunded.

RECOMMENDATION:

We recommend that the department disallow the deduction of estimated bad debts in compliance with section 84-1502, R.C.M. 1947, or seek legislation allowing a deduction which conforms with Federal tax law.

RESPONSE:

We concur. The audit staff has been instructed to disallow all deductions for estimated bad debts.

RECOMMENDATION:

We recommend that the department adequately document supervisory reviews of corporate tax accounts receivable credit adjustments.

RESPONSE:

We concur. Proper documentation is necessary for adequate internal control.

RECOMMENDATION:

We recommend that the department include a written audit program in all corporate tax field audit work papers.

RESPONSE:

We do have a formal written program on all aspects of field auditing. This program will be updated as needed.

RECOMMENDATION:

We recommend that the department audit small business and domestic corporations to insure compliance with Montana regulations.

RESPONSE:

We concur that the department should be auditing small business and domestic corporations on its own, but will continue to keep it a lower priority for the present due to limited staffing. Our emphasis has been in other areas, particularly large, out-of-state corporations. We do not agree with the report's conclusion that these small business and domestic corporations "can submit any information, and as long as the tax return is complete and totals properly, there is no prospect of audit by the division." Of course the statement means falsifying the returns. Corporations are required to reconcile their Montana net income to their Federal net income and submit a copy of the Federal return. Thus, they would also have to falsify their Federal return. It is our opinion that IRS does an excellent job of auditing corporations in Montana and all audit reports are provided to the state. None have ever revealed a case where a Montana corporation license tax return was deliberately falsified. We audit and adjust the Montana returns based on the audit reports.

PRIOR RECOMMENDATIONS:

Our response to recommendation one and three are included in our comments on the current report.

RECOMMENDATION:

Establish necessary procedures to facilitate the reconciliation of data processing totals for income tax collections to the cashier's totals by taxable year and reconcile these totals on a periodic basis.

RESPONSE:

We do not concur with this recommendation and have no plans for implementation. The implementation has not been essential to either the processing of income tax documents and refunds or the depositing of cash to the Treasurer's Office. Further, to establish the necessary procedures to be able to reconcile the differences between the two totals would mean much more keypunching and additional processing of the cashier's document, functions that would be very expensive. The routines necessary to ultimately arrive at reconciled differences of the totals are monumental in time and dollars compared to the value of the results. Our internal control of the tax return documents and the accompanying payments, in our opinion, is sufficient to provide the needed protection of state funds. The recent audit report of Newland, Horn, and Taylor will corroborate this statement. The financial data resulting from the reconciliation becomes somewhat insignificant when our test checks of the difference of the two totals is less than 1%. We do not believe that either the results or the costs are sufficient justification for the department to implement this recommendation.

RECOMMENDATION:

Consider the merits of revising the accounting and financial reporting system to break out and show separately the penalty and interest collected by the type of tax.

RESPONSE:

The design of the accounts receivable system to be in operation in January, 1977, has this capability. At that time this recommendation may be implemented.